Article

BANKS FACE LOOMING LOAN RESTRUCTURING

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This write up is intended to initiate academic debate on a pertinent question. It is not intended to be a professional advice and should not be relied upon for real life facts.

INTRODUCTION

The Indian Banking System is facing a prolonged difficult time. The alarming rise in the level of restructured advances has added fuel to fire on the astonishing estimated GDP growth rate of 5.5% of our Indian economy. The huge lending by the banks during the Financial year's 08-11 and on top of it the global and local economic downturn has led to higher restructuring of advances by the banks. The incredible rise in the frequency of knocking at the door of the CDR cell by various banks proves the looming restructuring of advances that the Indian Banking system is facing. At the present moment, there is a deluge of restructuring proposals piling up with banks. Many large corporates in core sectors such as steel, infrastructure, tourism, etc are queuing up before the CDR Cell. The reasons are quite obvious—cash-flows out of core sector projects are stuck, and in any case, lots of entities had over-leveraged themselves. Facts, Reports by various credit rating agencies like CARE and ICRA and RBI's guidelines and notifications are evidences supporting this alarming situation in the economy. Sources reveal that both Macro and Micro economic conditions are responsible for this. Restructured advances has a growth rate of 58.48% in Financial Year 2012 with a CAGR (Compounded Annual Growth Rate) compared to the growth of 42.54% during the period of Financial Years 2009 to 2012.The slow credit growth has led to weak economic growth/activity, risk-aversion trend of banks on stressed mid/large corporate (deteriorating its asset quality thereby giving rise to NPA/restructuring), and uncertain political situation with respect to land acquisition/environmental clearances reforms. Other reasons that caused the corporate in almost all the sectors to apply for restructuring are higher input costs causing suppressed margins, Sluggish global/local demand, and uncertain local political scenario.

FINANCIAL STABILITY REPORT ON STEEP RISE IN RESTRUCTURING OF ADVANCES ISSUED BY RBI

Financial Stability Report (issue no.6) throws light on the looming restructuring of advances faced by banks. Restructuring of loans, particularly of big ticket loans under the corporate debt restructuring (CDR) mechanism, has recently come under closer scrutiny due to the steep rise in the number and value of such advances. Between March 2009 and March 2012, while total gross advances of the banking system grew by less than 20 per cent (compound annual growth rate), the restructured standard advances grew by over 40 per cent. The proportion of restructured standard advances to gross total advances increased from 3.5 per cent in March 2011 to 4.7 per cent in March 2012. This has further increased to 5.9 per cent as at the end of September 2012. Some industrial sectors like iron & steel, infrastructure and textile experienced a much greater degree of restructuring of advances in the recent period. For more details refer Box 2.1 of the RBI Report.[1]

[1] http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/FFSR261212_FL.pdf

CARE RESEARCH REPORT[2]

CARE Research report lays emphasis on the figures depicting the struggling phase banks are facing. It has estimated the restructuring amount to be in the range of ~Rs. 3.8 – Rs. 4.0 trillion in Financial Year 2013which is expected to be achieved through CDR and bilateral mechanism in the ratio of 1:1. Number of CDR approvals this year has been around thirty four. Banks are restructuring their advances in the form of concessions by reducing the interest rate, rescheduling repayments, converting debt into equity/ preference share, and waiving principal/ interest (to a limited extent) to help the companies in improving its financial situation.

SECTOR-WISE ANALYSIS

Restructuring is not only sector specific but has become a common practice in almost every sector with varying frequency. *The major industries hit by the economic scenario* and applying for restructuring are the Iron & Steel, Infrastructure, Textile, Construction & Aviation, Cement, NBFC, etc. They have been the major contributors for increased restructured advances as they are unable to meet their obligations due to high interest cost. This has led to a record high restructuring of 4.7% in Financial Year 2012 as against 2.73% in Financial Year 2009. In spite of a fall in gross advances in 2012 from the year 201l there has still been a rise in restructured advances.

MACRO-ECONOMIC FACTORS

The Macro-economic reasons behind this are: sticky inflation path still persists, weak global growth prospects in both Advanced economies and in emerging and developing economy due to slack in output and employment, sluggish growth in India continues, the investment slowdown weakening the aggregate demand, liquidity crunches due to the falling demand conditions and distinctively lower credit expansion by public sector and foreign banks partly reflecting their risk aversion, higher ratio of gross and net non-performing assets and deteriorating asset quality of the public sector banks, market respond to reform measures.

MICRO-ECONOMIC FACTORS

Some of the Micro-economic reasons for restructuring, associated with the banking sector are aggressive lending strategy adopted, inadequate due diligence and bias towards known borrowers. These are more prevalent in the Public Sector Banks over the Private Sector Banks as Private Banks follows defensive lending, thorough due diligence mechanism and proactive account follow up to some extent.

INDUSTRY-SPECIFIC FACTORS

Some of the industry specific reasons are discussed here, the Iron and Steel had to face shrinking margins due to higher input cost, elevated leverage ratio (D/E), constrained mining due to Supreme court’s ban, poor infrastructure to transport coal, elevated landed

[2] http://www.moneycontrol.com/news/care-research/restructuringloansrise-care-research_818806.html

prices of imported raw material due to depreciating INR even though the global raw material prices have come down, making the project unviable. Only few/large integrated steel producers with adequate raw materials availability (own captive mines) are likely to survive in this atmosphere. Whereas, the infrastructure sector is facing this due to floundering demand from western countries (highly export-dependent industry) unstable margins due to high volatile cotton prices and depreciating rupee, elevated raw material prices, increase in manufacturers selling prices (coupled with higher excise duty), power shortage forcing units to shut down operations and deferred receivables leading to liquidity crunch in the industry.

BANK-WISE ANALYSIS

The higher provisioning norm on restructured advances shall hit the earnings of the banks drastically. While banks with higher provision cover, like Bank of Baroda and Union Bank, may have some cushion to offset the earnings hit and private banks would be least impacted with impact estimated at less than 0.5%. Indian Bank had 10.9% of its loans in restructured category, while the country's second largest lender PNB had 9.6% and OBC 9.5%. However, country's largest lender State Bank of India, which is also a public sector bank, had only 3.5% restructured loans. On the contrary, leading private sectors lenders ICICI, HDFC and Axis Bank had 1.5%, 0.3% and 2.4%, respectively.

DRAFT GUIDELINES ISSUED BY RBI, EXPECTED TO HIT THE EARNING OF BANKS

Reserve Bank has issued the draft guidelines on *'Review of Prudential Guidelines on Restructuring of Advances by Banks and Financial Institutions'* in the light of the recommendations of the Working Group (WG) guidelines issued in July, 2012, held under the chairmanship of Shri B. Mahapatra. The draft guidelines contain several technical details regarding prudential norms on income recognition, asset classification and provisioning as well as on substantive and procedural issues pertaining to the restructuring process itself.[3]

PROVISIONING NORMS

The new draft guidelines for restructured loans are likely to hit earnings of banks by at least 3-8% over the next two years primarily affecting the Public Sector Banks. It majorly talks about stepping up the provision on restructured loans to 3.75% from FY 2014 and to 5% from FY 2015. The widespread impact of the guideline shall be that banks will upgrade a restructured loan to a 'standard loan' in their accounts if the loans have been performing for a specified period. Upgrading may "partly mitigate" the impact, as in some instances 30-40% of reported restructured loans could be upgraded, to reduce the burden of higher provision required to be made on restructured loans. It would act as a deterrent to "shallow" restructuring that tends to happen in the banking sector. RBI has invited feedback on the draft guidelines issued by it till February 28, 2013. It shall then

[3] http://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2640

come up with the final guideline considering the feedbacks on the draft, restraining the looming restructuring scenario cause by systemic crisis.

CONCERNING ASSET CLASSIFICATION

As far as classification is concerned, the current system of regulatory forbearance will be continued until April 1, 2015, whereby "standard accounts are allowed to retain their asset classification and [non-performing asset (NPA)] accounts are allowed not to deteriorate further in asset classification on restructuring". However, from April 1, 2015, this would change and classification benefits available on restructuring may be withdrawn. There are other specific guidelines relating to the treatment.

DISCLOSURE REQUIREMENTS: In line with RBI's Notification dated 31.01.2013 on Disclosure Requirements of Advances Restructured by Banks and Financial Institutions.[4]

According to paragraph 16 of Master Circular dated 02.07.12, on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances, banks should disclose under "Notes on Accounts" in their published Annual Balance Sheets, information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances under the categories Standard Advances Restructured, Sub-Standard Advances Restructured and Doubtful Advances Restructured. Restructuring of standard and sub-standard class of assets are covered in Category-I, while cases of doubtful assets are covered under Category-II. Under each of the category advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories of restructuring are required to be shown separately. Restructured advances under their present asset classification, i.e. standard, substandard, doubtful and loss should be shown separately.

Further, in case any restructured advance which was classified under the standard category from the very beginning or an NPA which was upgraded to the standard category reverts back to normal level by satisfactorily performing the dues, then the bank is no longer required to disclose it as a restructured account in the notes on accounts of the Balance Sheet. Whereas the diminution in fair value of restructured accounts should continue to be maintained. The disclosure requirement has been implemented and is no more under a draft form.

RBI GUIDELINE TO ACT AS A DETERRENT TO SHALLOW THE LOOMING RESTRUCTURING

The effort seems to streamline and tighten the restructuring process further. Only those cases where the viability of the unit (within a relatively shorter period of time) is guaranteed may be taken up for restructuring. Greater contribution is sought from promoters for restructurings so that they retain a "skin in the game" – these could be in

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[4] http://rbidocs.rbi.org.in/rdocs/content/pdfs/REDI310113_A1.pdf

the form of promoter's sacrifice and additional funding as well as personal guarantees. Overall, the guidelines seem to be more prescriptive in terms of regulating asset provisioning and corporate debt restructuring. While they place filters to ensure that only the most deserving cases will be subject to turnarounds, greater regulatory intervention (as opposed to forbearance) may reduce the incentive to companies and lenders to pursue restructuring as an option if the process becomes too cumbersome.[5]

CONCLUSION

A higher pace of recovery in NPA's is expected and this will restrain the restructuring level. Predictions are made that the economic revival will be U-shaped instead of V-shaped. This is because the revival will be prolonged due to the present economic structure and it will take time for the economy to stabilize and the slope of revival will not be steep enough to result in a V-shaped revival. Furthermore, RBI's notifications and guidelines on disclosure of restructured advances by banks, on asset classification and provisioning norms for restructured accounts would act as an effective step to reduce the level of restructured advance for most banks. ICRA expects a 15 to 30% reduction in restructured advances due to the incremental provisioning requirement proposed by RBI.[6]

Read our articles and notes on (relevant topic related to the article/note) at: http://india-financing.com/banking-regulations.html

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[5] http://www.goodreturns.in/news/2013/02/04/draft-norms-restructured-loans-impact-re-159327.html

[6] http://www.icra.in/Files/ticker/Restructuring%20comment-icra.pdf